Testimony of Lawrence Kudlow

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It is a pleasure to appear before the Subcommittee on Domestic Monetary Policy, Technology, and Economic Growth.

Let me be as brief as possible. Attached to my testimony is a series of charts that illustrate some of today's economic issues.

We are in the midst of the first significant economic and stock market slump in ten years. The stock market decline began roughly one year ago. The economic downturn first appeared in last year's third quarter. Market indexes have entered bear territory, defined as a 20% drop registered over a period of at least six months. As for the economy, I estimate the probability of recession to be roughly 50%.

In terms of identifying the causes of the current economic problem, I believe excessively tight Federal Reserve policies deserve special mention. Our nation's central bank continued to tighten policy last year despite the emergence of an inverted Treasury yield curve, a classic recession signal, and declining gold and commodity prices. After expanding the monetary base by roughly 16% in 1999, itself an overly accommodative policy, the Fed proceeded to deflate this measure of high-powered liquidity at a 2½% rate in 2000. It is one of the largest swings from stimulus to restraint in history.

Repeated energy shocks in 1999 and 2000 also play a role in the downturn. The upward price swing in various energy commodities caused a roughly $65 billion transfer of incomes from U.S. consumers to OPEC producers. Additionally, higher prices for oil, home heating fuel, natural gas, auto gasoline fuel, electricity and other energy goods caused roughly $100 billion of consumer spending to be diverted from non-energy purchases to pay these energy bills. As a rough approximation, it could be argued that the energy shock lowered gross domestic product by as much as two percentage points cumulatively since early 1999.

Another economic problem has been the rising incidence of what is called real income tax bracket creep. I estimate this to be in the neighborhood of $125 billion over the past four quarters. Successful workers have been pushed into higher tax brackets as real incomes have increased. So within the tax system, millions of people have experienced higher tax rates.

All this said, the question is what to do about it? Obviously, Federal Reserve policies have belatedly turned more stimulative. This is a good thing, though the monetary authority has much more work to do. I believe its overnight policy rate should be lowered to 4% as soon as possible from the current 5% level. In all likelihood a 3½% fed funds rate will become appropriate before the easing cycle is complete. Monetary base growth has accelerated slightly to 3½%. I believe the year-to-year change in this key measure of high-powered bank reserves should range between 6% and 10%.

Hopefully, U.S. energy policies will tilt substantially more in the direction of producing oil and gas in the period ahead. Our information technology economy requires substantial additions to the stock of electricity in order to fuel the wired economy. Hence, greater production of natural gas will be necessary. Also, renewed interest in nuclear energy is appropriate. A tougher U.S. diplomatic stance with respect to OPEC production decisions also seems appropriate. Free markets, not commodity cartels, should be permitted to set world prices.

Finally, tax reduction should be called on to play a major economic recovery role. There is much debate on this whole issue right now. Let me weigh in.

I believe the best thing we can do to restore the stock market and economic growth is to provide shock therapy in the form of immediate reduction for personal tax-rates across-the-board and the capital gains tax rate. As quickly as the legislative process permits, the best thing lawmakers can do this year is to lower personal and capital gains tax-rates retroactively to January 1, 2001. Later on, pension tax reforms should move forward unlimited and universal IRAs and 401(k)s. Estate tax reform and corporate tax reform are also pro-recovery measures. All these reforms will raise the economy's long-run potential to grow.

The biggest problem facing the economy is the loss of capital and the deflation of wealth that has occurred over the past year. The Federal Reserve Board has, ironically in view of their culpability, reported a $2 trillion family wealth decline for 2000. Various market analysts estimate the decline of stock market wealth to range between $4 trillion and $5 trillion. Along with the shrinking economic growth rate, these massive wealth losses have substantially increased investment risk premiums and capital cost. Risk-taking has sunk to low ebb.

Meanwhile, recent economic statistics show that the supply-side of the economy is sagging badly. Non-defense capital goods orders have fallen in four of the past five months. Capital goods shipments have dropped 14% at an annual rate over the past three months. This includes technology shipments, where orders for industrial machinery goods and electrical machinery have fallen by, respectively, 7% and 13.9%, both at annual rates. Substantial inventory overhangs exist in virtually all industrial and technology sectors. Meanwhile, the index of industrial production has declined five consecutive months. This important coincident indicator is flashing recession. So is the index of leading indicators, which are now declining on a twelve-month rate of change basis.

In light of these data, proposals for a one-time consumer tax rebate make no sense at all. Right now consumption is not the biggest economic problem. In fact, inflation-adjusted personal spending increased at a nearly 3% annual rate in the fourth quarter, and looks to be rising at roughly 3% in this year's first quarter.

But domestic business investment declined by nearly 4% in the fourth quarter of 2000, and, judging by the disappointing factory numbers, will decline again the first quarter, perhaps by as much as 5% annually. Though some economists disagree, I believe that consumer spending and personal income is ultimately generated by investment and production increases. Classical economists have long argued that we invest and produce in order to consume. Production generates jobs, jobs create income, and income provides the resources for consumer spending.

If, on the other hand, the decline of investment and production is not halted, then the downturn will produce significant unemployment. This will undermine personal incomes and consumption. So it is my view that one-time consumer tax rebates, which have no permanent economic impact, nor any behavioral impact, is putting the cart before the horse. Really, a waste of money.

Instead, current conditions warrant tax relief measures that will stimulate investment and production. Incentive rewards need to be raised, and after-tax capital costs must be reduced. The surest way to achieve this goal is a permanent reduction in the marginal tax-rates on personal income and capital gains. Bear in mind that upper bracket income earners are the primary source of capital for our economy. Also, nearly one-fifth of upper bracket tax filings are made by small operator-owned businesses, Sub-Chapter S companies, limited liability partnerships and so forth.

Therefore, reduced personal tax-rates will lower capital cost hurdle rates for investment and will increase after-tax rewards for additional investment risk-taking. The economy has suffered a major deflation of capital and wealth. By relieving tax burdens on capital and wealth, we can begin to resurrect the supply-side sector of the economy. Dropping the tax-rate on capital gains should be a major component of this recovery plan. Capital gains relief, as you know, is a self-funding tax-cut that will actually stimulate a surplus of future revenues.

The compression of equity asset values over the past year has unleashed numerous adverse consequences to technology innovation and new business formation. Price-earnings multiples in the S&P 500 stock index have shrunk from 33 to 22. At 33 times earnings, the earnings yield on S&P stocks was 3% a year ago. However, at 22 times earnings today, the earnings yield has jumped to 4.5%. This means that equity financing has become 50% more expensive, a considerable deterrent to business and capital expansion. Entrepreneurs right now are starved for credit.

As a result, equity funding for initial public offerings or other forms of venture capital is now virtually non-existent. Entrepreneurs could of course apply to commercial banks and other lenders, but lending standards have tightened substantially in recent months, virtually foreclosing this credit source.

In order to revive sinking investor spirits, I recommend the shock therapy of immediate tax-rate reduction, made retroactive to the beginning of this year, for personal tax-rates and capital gains. This would provide a positive jolt to stock market sentiment, a positive jolt to venture capital financings, and a positive jolt to risk-taking in general.

In short, rapid and accelerated tax-rate relief on incomes and capital would provide a positive jolt to the entrepreneurial spirits of the economy.

This is what it will take to move the U.S. economy back toward the 5% growth path that we experienced before the Federal Reserve embarked on its unnecessary policy errors that eviscerated the stock market and de-funded the economy.

Technology innovation is the backbone of our modern economy. Tremendous contributions to technology investment have increased productivity gains and economic returns everywhere. But innovation and investment require new incentives if we are to overcome the deleterious effects of the stock market plunge and the economic downturn. Reducing tax-rates on personal income and capital gains will raise the return and lower the after-tax cost of capital, thereby at least partially offsetting the significant capital cost increases and newly-imposed investment risk premiums that the economy has suffered as a consequence of the stock market plunge.

Entrepreneurs and investors will welcome such policies. So will ordinary working families. Over 100 million Americans today own stocks. Over 130 million Americans today are employed in business. Everyone will benefit from permanent reductions in the tax-rates on income and capital.

Thank you for giving me an opportunity to provide this testimony.